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IFRS Developments

IASB issues new leases standard

What you need to know

- The IASB issued a new standard that requires lessees to recognise most leases on their balance sheets.
- Lessees will have a single accounting model for all leases, with certain exemptions.
- Lessor accounting is substantially unchanged.
- The new standard will be effective from 1 January 2019 with limited early application permitted.

Highlights

The International Accounting Standards Board (IASB or Board) issued IFRS 16 *Leases* (IFRS 16 or the new standard), which requires lessees to recognise assets and liabilities for most leases. For lessors, there is little change to the existing accounting in IAS 17 *Leases*.

The IASB issued its standard as part of a joint project with the Financial Accounting Standards Board (FASB). The FASB has not yet issued its new standard, but it is also expected to require lessees to recognise most leases on their balance sheets. However, the IASB and FASB made different decisions during deliberations, and differences between the two standards will exist (e.g., there would be a classification test for lessees under the FASB's standard).

The new standard will be effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers,* has been applied, or is applied at the same date as IFRS 16.

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Key considerations

Determining whether an arrangement contains a lease

Under the new standard, a lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of an identified asset, which could be a physically distinct portion of an asset such as a floor of a building.

A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to: (1) obtain substantially all of the economic benefits from the use of the identified asset; and (2) direct the use of the identified asset (i.e., direct how and for what purpose the asset is used).

How we see it

Determining when a customer has the right to direct the use of an identified asset may require significant judgement, particularly for arrangements that include significant services. While the new standard provides new criteria for determining whether an arrangement meets the definition of a lease, we expect that entities generally will reach similar conclusions as they do today.

Identifying and separating lease and non-lease components of a contract and allocating contract consideration

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (i.e., non-lease components such as maintenance). For these contracts, the non-lease components are identified and accounted for separately from the lease component, except lessees can make an accounting policy election, by class of underlying asset, to account for both components as a single lease component. Lessees that do not make this policy election are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. Lessors are required to apply IFRS 15 to allocate the consideration in the contract.

Lessee accounting

Initial recognition and measurement

Lessees will recognise most leases on their balance sheets.

Lessees are required to initially recognise a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term.

The lease liability is measured at the present value of the lease payments to be made over the lease term. The right-of-use asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are permitted to make an accounting policy election, by class of underlying asset, to apply a method like IAS 17's operating lease accounting and not recognise lease assets and lease liabilities for leases with a lease term of 12 months or less (i.e., short-term leases). Lessees also are permitted to make an election, on a lease-by-lease basis, to apply a method similar to current operating lease accounting to leases for which the underlying asset is of low value (i.e., low-value assets).

Subsequent measurement

Lessees accrete the lease liability to reflect interest and reduce the liability to reflect lease payments made. The related right-of-use asset is depreciated in accordance with the depreciation requirements of IAS 16 *Property, Plant and Equipment*. For lessees that depreciate the right-of-use asset on a straight-line basis, the aggregate of interest expense on the lease liability and depreciation of the right-of-use asset generally results in higher total periodic expense in the earlier periods of a lease. Lessees remeasure the lease liability upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate), which is generally recognised as an adjustment to the right-of-use asset.

Lessees apply alternative subsequent measurement bases for the right-of-use asset under certain circumstances in accordance with IAS 16 and IAS 40 *Investment Property*.

Right-of-use assets are subject to impairment testing under IAS 36 *Impairment of Assets*.

Presentation

Right-of-use assets are either presented separately from other assets on the balance sheet or disclosed separately in the notes. Similarly, lease liabilities are either presented separately from other liabilities on the balance sheet or disclosed separately in the notes. Depreciation expense and interest expense cannot be combined in the income statement. In the cash flow statement, principal payments on the lease liability are presented within financing activities; interest payments are presented based on an accounting policy election in accordance with IAS 7 *Statement of Cash Flows*.

Lessor accounting

Initial recognition and measurement

Lessor accounting is substantially unchanged.

The accounting by lessors under the new standard is substantially unchanged from today's accounting in IAS 17. Lessors classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases: operating and finance leases.

For operating leases, lessors continue to recognise the underlying asset.

For finance leases, lessors derecognise the underlying asset and recognise a net investment in the lease similar to today's requirements. Any selling profit or loss is recognised at lease commencement.

Subsequent measurement

For operating leases, lessors recognise lease income on either a straight-line basis or another systematic basis that is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

For finance leases, lessors recognise interest income for the accretion of the net investment in the lease and reduce that investment for payments received. The net investment in the lease is subject to the derecognition and impairment requirements in IFRS 9 *Financial Instruments*.

Sale and leaseback transactions

A seller-lessee and a buyer-lessor use the definition of a sale from IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. If the transfer of the underlying asset satisfies the requirements of IFRS 15 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor. If not, the transaction will be accounted for as a financing by both the seller-lessee and the buyer-lessor.

How we see it

The new determination of whether a sale has occurred in a sale and leaseback transaction is a significant change from current practice. For example, IAS 17 focuses on whether the leaseback is an operating or finance lease, and does not explicitly require the seller-lessee to determine whether the sale and leaseback transaction meets the condition for the sale of the asset. We generally expect fewer transactions to be accounted for as sales and leasebacks under the new standard.

Transition

The new standard permits lessees to use either a full retrospective or a modified retrospective approach on transition for leases existing at the date of transition, with options to use certain transition reliefs.

Next steps

IFRS 16 is a significant change from current IFRS, in particular for lessees. Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. Entities will also need to ensure that they have the processes (including internal controls) and systems in place to collect the necessary information to implement the new standard.

Further resources

- Our Thought Center webcast, *An introduction to the new leases standard*, is scheduled for 19 January 2016; registration details are available on www.ey.com/ifrs.
- Our *Applying IFRS* series will be available in the coming months to provide in-depth discussion of the requirements of IFRS 16 including illustrative examples.

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